In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-816

CARR STALEY, INC., PETITIONER

v.

UNITED STATES OF AMEAICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The sole question raised by the petition is whether Section 636(b) of the Internal Revenue Code of 1954, which provides that a production payment retained on the sale of mineral property shall be treated as a purchase money mortgage loan and not as an economic interest in the property, is constitutional.

On January 1, 1972, petitioner purchased from Alfred B. Guinn an undivided one-sixteenth working interest in an oil and gas lease for $7,000. Petitioner made a $2,000 cash down payment and Guinn reserved a $5,000 production payment, bearing interest at 10 percent per annum, payable out of 70 percent of the minerals produced and attributable to the one-sixteenth working interest. In addition, Guinn was to receive an amount equal to all ad valorem taxes assessed against the property represented by the production payment.

As holder of the working interest, petitioner agreed to permit Medders Petroleum Corporation to conduct the oil exploration program and to extract the oil from the leased premises. Atlantic Richfield bought the oil produced from the leased premises as it was removed from the ground, paying petitioner $549.90 for its interest and paying Guinn $1,283.09, which equalled his retained production payment in the one-sixteenth working interest (Pet. App. A5-A8).

Although petitioner reported the entire income attributable to this undivided one-sixteenth working interest, it filed a claim for refund, asserting that Section 636(b), which required it to include in income the amount paid to Guinn, was unconstitutional. The district court upheld the constitutionality of that statute (Pet. App. A23-A25), and the court of appeals affirmed (Pet. App. A1-A22).

1. Under Article I, Section 8, of the Constitution, Congress has the power to "lay and collect taxes," and under the Sixteenth Amendment, the "power to lay and collect taxes on incomes, from whatever source derived." *Brushaber* v. *Union Pac. R.R.*, 240 U.S. 1, 24-25; *Burnet* v. *Wells*, 289 U.S. 670, 679; *Steward Machine Co.* v. *Davis*, 301 U.S. 548, 584. Section 636(b) of the Code was added as part of the Tax Reform Act of 1969 (P.L. 91-172, 83 Stat. 487), to counter the preferential tax treatment afforded the oil and gas industry through the development of the economic interest concept. *Thomas* v. *Perkins*, 301 U.S. 655; *Anderson* v. *Helvering*, 310 U.S. 404, and *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308.

Under these authorities, upon the sale of an oil or gas interest for consideration which includes a reserved production payment, the holder of the retained production

payment is deemed to have received the income for that payment, subject to percentage depletion, during the payout period. The working interest holder, who was obligated to develop and produce the minerals (see *Commissioner* v. *P.G. Lake, Inc.*, 356 U.S. 260, 261), was permitted to exclude the amount paid to the transferor, and was thereby able to satisfy the production payment (which constituted part of the purchase price of the working interest) from pre-tax earnings. See S. Rep. No. 91-552, 91st Cong., 1st Sess., pp. 182-183.

Noting that the utilization of such devices had enormously increased in recent years, producing an estimated revenue loss of between $200,000,000 and $350,000,000 annually, Congress concluded that "there is no reason why a person who, in effect, is the borrower in a production transaction should be allowed to pay off the loan with tax-free dollars while a borrower of funds in any other industry must satisfy the loan out of taxed dollars." S. Rep. No. 91-552, *supra*, at pp. 183-184. In light of this disparity between retained oil and gas production payments and other types of purchase money mortgages, Congress decided that all production payment transactions should be treated "as loan transactions; that is, a loan by the owner of the production payment to the owner of the mineral property" (*ibid.*).[1]

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[1]The new statute extended to all retained production payment situations the rule of prior decisions that where the payment to the seller was guaranteed, the purchaser was required to report the gross proceeds derived from oil production, subject to the allowance for depletion, notwithstanding the arrangement to pay over part of them to the seller. See *Commissioner* v. *Estate of Donnell*, 417 F.2d 106, 113-116 (C.A. 5); *Anderson* v. *Helvering*, *supra*; S. Rep. No. 91-552, *supra*, at pp. 184-185.

Such a legislative classification is neither arbitrary nor capricious. As the court of appeals observed in upholding the constitutionality of Section 636(b):

> The legislative scheme under review is a reasonable measure by Congress to remove the unequal and unjust treatment of taxpayers which occurs merely from the form of the transaction employed [Pet. App. A22].

2. Contrary to petitioner's contention (Pet. 5-9), the decision below does not conflict with *Hoeper* v. *Tax Commission*, 284 U.S. 206. In *Hoeper*, the Court held that a Wisconsin statute which taxed the combined incomes of the husband and the wife to the husband alone violated the due process and equal protection clauses of the Fourteenth Amendment, where the husband had no title, right, or control over the wife's income under Wisconsin law. But as the Court subsequently explained in *Reinecke* v. *Smith*, 289 U.S. 172, 178, the basis of *Hoeper* was that the husband never had title or control over either the property or the income from it.

Here, however, petitioner had full control over the oil producing property in question, and contracted to make the production payments to Guinn as a means of satisfying the full purchase price of the working interest in the oil. Although state law gave Guinn, as owner of the production payments, an interest in the realty, the economic substance of the transaction was that the production payments were employed to pay off petitioner's debt to Guinn. Such payments thereby benefited petitioner in the first instance. Under these circumstances, the Court has often held that income may be taxed to the person who controls either the property producing the in-

come or the disposition of the income itself, notwithstanding the fact that another party may hold the legal title to the property in question. See, *e.g.*, *Corliss* v. *Bowers*, 281 U.S. 376; *Helvering* v. *Clifford*, 309 U.S. 331; *Burnet* v. *Wells*, *supra*, 289 U.S. at 678.

3. Finally, petitioner contends (Pet. 9-10) that the decision below conflicts with *Heiner* v. *Donnan*, 285 U.S. 312, and *Schlesinger* v. *Wisconsin*, 270 U.S. 230. In those cases, the Court rejected as arbitrary and capricious irrebutable presumptions that transfers made within a certain period of time from the decedent's death were in contemplation of death, and thereby subject to estate tax. However, the statute at issue in this case does not employ an irrebutable presumption. To the contrary, in enacting Section 636(b), Congress concluded that the essential identity of reserved production payments and purchase money mortgages merited similar tax treatment.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

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